

Weighing up the *risk*

Analysts and politicians on both sides of the Atlantic in the past 12 months have called for all the key players in the home loan securitization process to hold on to some of the risk. Forcing the various participants to invest in their own cooking, the argument goes, will align their interests with the end investors and help breathe life back into the market for private-label mortgage securitization.

Under the right circumstances, the argument is, this would help ensure reliable credit in the underlying loans. But in practice, the complexity of using mandatory retained risk to align interests argues for a more efficient approach: disclosure sufficient to let the market put a price on alignment.

The case for retaining risk goes right to the problem of potentially misaligned interests between mortgage-backed securities investors and the long line of agents working for them. After all, these investors rely variously on mortgage brokers, bankers, underwriters, ratings agencies and servicers to screen and later help monitor and manage credit risk in the securitized loans. Investors rarely have the capacity to do all this on their own. It's the role of efficient agents to help investors buy a more diversified pool of risk at a lower cost.

With diversification and efficiency, however, comes the risk that one or more of the agents end up at odds with the investors. Mortgage brokers, for instance, may get paid more for cranking out loan volume than for ensuring loan quality. Bankers and underwriters may have incentives to wax poetic about loan quality to get securities distributed at a lower yield. And servicers getting paid a fixed, and some may argue low, fee may have incentives to reduce costs rather than reduce losses.

All of these agents already do have a stake in producing quality loans — not least their reputation and the desire to win more business in the future — but that can be overwhelmed by other incentives or made irrelevant by an agent's lack of capital or other resources to back up their implied or actual obligations. All of these potential conflicts have surfaced in different diagnoses of the abysmal credit in many 2006-2008 private-label securitizations.

If investors have reason to doubt agents' alignment, then the compensation required to bear new securitized risk might end up just about where it is today — off the charts. Securitization of new non-agency originations has dropped from a peak of more than

By Steven Abrahams

There is widespread pressure for those involved in mortgage securitization to retain a portion of the risk in order to keep their interests in line with investors and thus reduce poor lending decisions. Retaining risk sounds straightforward in principle but is complex in practice.



Some good ideas have a tendency to add too onerous a burden

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\$1.1 trillion in 2005 and 2006 to zero in the first nine months of this year (See chart on pg. 12). Certainly, a lot of factors have contributed to the drop including regulatory pressure on originators, lack of financing for new loans, limited capital at banks and occasionally better investment opportunities elsewhere.

Ultimately, however, the market has struggled to find a price for credit that readily brings new private-label borrowers and investors together. The argument would appear to be strong, then, for distributing risk and creating clear and compelling economic incentives for everyone along the securitization chain to think like an investor about credit.

Retain Some Risk? Not So Fast ...

Retaining risk sounds straightforward in principle but gets complex in practice. Effective retention should parallel each agent's ability, in both magnitude and timing, to influence the credit of the securitized loans. That implies matching one or more classes in a standard securitization to the influence of each key agent, or even structuring new classes just for retention.

An originator selling loans into a securitization, for example, arguably only has primary influence on performance for a few years, and even then mainly in a normal housing mar-

ket. If borrowers then default more or less than average during that period, the originator should bear corresponding penalty or reward. This loosely lines up with the risk/return profile of a first-loss class in many securitizations, a class where small differences in the rate of principal loss can drive big differences

in returns. Retaining part or all of a first-loss class would give the originator incentives commensurate with its influence.

However, the selling originator should not have to bear risks beyond its control, such as a catastrophic downturn in housing or poor loan

performance long after origination. Catastrophic housing risk — downturns that traditionally generate losses in the highest investment-grade classes — seems better borne by investors. Operational credit risk seems best borne by servicers, who continue to influence loan performance long after origination. A servicer, for example, might be required under new rules to hold a vertical slice of a securitization, a pro-rata participation in each class, to parallel the servicer's influence throughout the life of a loan.

But this raises two other issues. First, how much risk should each player retain? To keep the agent aligned with the investor, the value of the retention should make up a material part of the agent's total profits. If an originator's fees from mak-

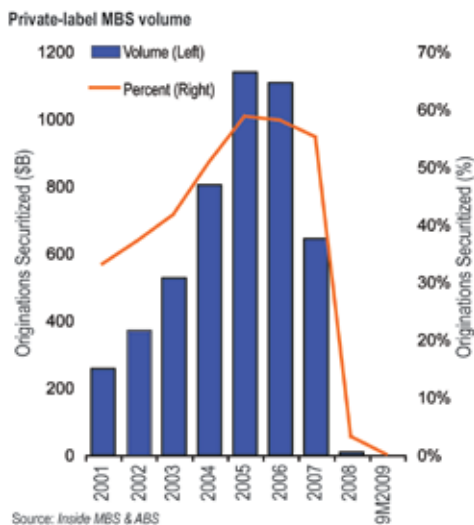
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ing loans dwarf the value of risk retained, for instance, then the originator could still sanction poor credit without sacrificing material profitability.

Likewise, if a servicer's stake is small, the servicer has little incentive to defend it. Second, no matter the design or size of the retention, allowing the agent to hedge away the risk would similarly defeat the purpose behind retaining it. Aligned agents need to bear material unhedged credit risk.

Getting all of this right is tricky. In a report published last October entitled *Restarting Securitization Markets: Policy Proposals and Pitfalls*, analysts at the International Monetary Fund (IMF) argued that effective retention would require a complex matrix of rules difficult to operate in practice. U.S. and European proposals to require a 5% minimum retention by issuers, the IMF analysis argues, seem too simple. That approach might align issuer and investor interests in some securitizations but not in others. Where loan quality would lead to a cumulative 5% loss in a normal housing market, for instance, the issuer and investor might be aligned.

But a subprime issuer expecting higher losses might see a 5% retention as an inevitable and quick loss, and not worth the effort to aggressively police loan quality. And a prime jumbo issuer expecting much lower losses might see 5% as a burden well beyond its ability to influence credit. Fixed retention conse-



quently could have the unintended effect of distorting the cost and supply of mortgage credit. Any risk retention rules would require much more subtlety.

Disclosure Over Diktat

That's why disclosure may work better than diktat to encourage retention in forms and amounts that best align securitization agents and investors. German academics Günther Franke and Jan Pieter Krahen argue a similar line in their 2008 paper *The Future of Securitization*. Disclosure would give investors enough information to allow the market to put a price on the quality of agent alignment. Loans securitized by a tightly aligned set of originators, issuers and servicers would trade at a higher price than otherwise. And if that price is high enough, then the tight-

ly aligned set of agents would enjoy a pricing advantage over competing lenders.

Those agents would win share in the lending market. And competition should then drive lenders to refine risk retention to forms and amounts that command the highest price from inves-

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tors, justifying the effort and potential capital required for the retention.

The Committee on Capital Markets Regulation, a private research group, has argued for exactly the kind of disclosure that would help investors evaluate most of the major facets of agent alignment. In a paper released in May last year entitled *The Global Financial Crisis: A Plan for Regulatory Reform*, the committee recommended releasing more information on the following areas: the value of the retained interest; the structure of the retained interest; the intended period of retention; the ability and intent of the agent to hedge; and the estimated amount of fee income or other profits earned by the agent through the securitization

This kind of disclosure, regularly updated and audited, would enable the market to put a price on the alignment of investors and agents in a securitization. The market could determine the amount and form of risk and the agents that retain it. Securitized markets may have proven themselves imperfect in recent years at pricing risk, but disclosure and market pricing offer a more refined and flexible approach to creating alignment than mechanisms requiring rule-making, oversight and enforcement.

Most analysts and policymakers still recognize the benefits of healthy securitization: the operating efficiencies, the risk diversification, the transfer and restructuring of risk to suit the preferences and abilities of different investors, the lower cost of capital. The continuing robust activity in the agency mortgage market shows the potential of securitization as long as investors have the ability to readily evaluate risk in the securitized asset.

But the private-label mortgage market is currently broken. Back in 2006, private-label securitization funded 36% of U.S. residential mortgage loans. Through September this year, although origination of all mortgage loans has totaled \$1.4 trillion, private-label securitization has funded none. Its proponents have a lot of work to do to lure back an audience. High on the list should come the clear alignment of interests between securitization agents and investors. Disclosure may be the fastest and most efficient way to get us there. ▼

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